

## Message Text

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ACTION ARA-10

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FM AMEMBASSY MEXICO

TO SECSTATE WASHDC 6209

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ALL CONSULATES MEXICO VIA POUCH

C O N F I D E N T I A L MEXICO 9148

EO 11652: GDS

TAGS: EGIN MX

SUBJECT: MEXICAN ECONOMY AT MID-YEAR

SUMMARY: GOM 1976 EFFORT TO REDUCE INFLATION AND CURRENT ACCOUNT DEFICIT, LARGELY TO MAINTAIN PRESENT PESO-DOLLAR EXCHANGE RATE, IS NOT GOING VERY WELL: INFLATION CONTINUES AT RATE SIGNIFICANTLY HIGHER THAN IN U.S.; SIGNIFICANT CAPITAL FLIGHT CONTINUES; AND INFLATIONARY WAGE SETTLEMENTS BEING MADE IN PRIVATE SECTOR DO NOT AUGUR WELL FOR PUBLIC SECTOR LABOR NEGOTIATIONS NOW BEGINNING. ECHEVERRIA ADMINISTRATION CAN PROBABLY AVOID DEVALUATION SINCE ITS FOREIGN BANKERS SEEM WILLING TO FINANCE CAPITAL FLIGHT AT CURRENT LEVELS. HOWEVER, NEW LOPEZ-PORTILLO ADMINISTRATION WILL FACE DIFFICULT POLICY CHOICES. END SUMMARY.

1. MEXICO'S 1976 ECONOMIC GAME PLAN IS GEARED AT SLOWING DOWN RATE OF INFLATION AND REDUCING CURRENT ACCOUNT DEFICIT LARGELY BY EXERCISING GREATER CONTROL OVER PUBLIC SECTOR SPENDING. MAJOR OBJECTIVE OF PROGRAM IS TO ENABLE GOM TO MAINTAIN PRESENT PESO-DOLLAR EXCHANGE RATE. DIRECTOR GENERAL OF BANK OF MEXICO RECENTLY EXPRESSED HIS CONCERN TO AMBASSADOR THAT PROGRAM NOT  
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AS SUCCESSFUL AS MIGHT BE HOPED, CITING IN PARTICULAR CONTINUING

CAPITAL FLIGHT AND EXCESSIVE, FOR CIRCUMSTANCES, WAGE DEMANDS. MAKING ECONOMY FIT EXCHANGE RATE IS RATHER STRANGE POLICY TO PURSUE IN WORLD OF FLOATING RATES, BUT REFLECTS INTER ALIA BELIEF THAT MEXICO COULD NOT IMPLEMENT STABILIZATION PROGRAM, PARTICULARLY IN AREA OF INCOME POLICY, THAT WOULD MAKE DEVALUATION WORK. THAT IS, SUBSEQUENT INFLATION WOULD NEGATE ANY IMPROVEMENT IN MEXICO'S COMPETITIVE POSITION.

2. STATISTICS BY WHICH GAME PLAN'S IMPLEMENTATION CAN BE JUDGED ARE PARTIAL AND NOT VERY ENCOURAGING. PRICES CONTINUE TO RISE AT RATE ABOVE THAT IN U.S. WHOLESALE PRICE INDEX IN JUNE WAS 8.6 PERCENT ABOVE THE DECEMBER 1975 INDEX, AND 13.9 PERCENT ABOVE JUNE 1975 LEVEL. CONSUMER PRICE INDEX IN JUNE WAS 6.9 PERCENT ABOVE DECEMBER 1975 INDEX AND 11.6 PERCENT ABOVE JUNE 1975 FIGURE.

3. WHILE THE CURRENT ACCOUNT DEFICIT IN FIRST QUARTER OF 1976 WAS ALMOST 20 PERCENT BELOW THAT OF FIRST QUARTER OF 1975, FINANCING REQUIREMENT (CURRENT ACCOUNT DEFICIT PLUS ERRORS AND OMISSIONS ADJUSTED FOR SHORT-TERM CAPITAL MOVEMENTS BETWEEN MEXICO AND U.S. BANKS AND PUBLIC SECTOR EXTERNAL DEBT AMORTIZATION) WAS SUBSTANTIALLY HIGHER (\$1.5 BILLION VS. \$1.0 BILLION). THIS WAS DUE, IT APPEARS, TO LARGE-SCALE CAPITAL FLIGHT WHICH HAS CONTINUED TO PRESENT, THOUGH HIGH POINT WAS REACHED IN HOLY WEEK. IMPACT OF CAPITAL FLIGHT ON RESERVES HAS BEEN ABATED BY USE OF DOLLAR DEPOSITS IN MEXICAN BANKING SYSTEM. THESE DEPOSITS PAY INTEREST RATES ABOVE THOSE AVAILABLE IN U.S. (7.5 PERCENT FOR 3-MONTH CERTIFICATE OF DEPOSIT) AND CENTRAL BANK IMPOSES 80 PERCENT RESERVE REQUIREMENT ON THESE DEPOSITS, THEREBY CAPTURING BULK OF FLIGHT FROM PESO THAT TAKES THIS FORM. WHILE NO DATA YET AVAILABLE ON TRANSFERS FROM PESO TO DOLLAR ACCOUNTS, WE UNDERSTAND SWITCHES HAVE SURPASSED \$500 MILLION, WHICH IS SUBSTANTIAL PORTION OF MEXICO'S FOREIGN EXCHANGE RESERVES. IMPROVEMENT IN CURRENT ACCOUNT REFLECTS HIGHER PETROLEUM EXPORTS, HIGHER COFFEE PRICES AND LOWER IMPORTS OF FOODSTUFFS. MANUFACTURED EXPORTS, WHICH IT WAS HOPED WOULD SUPPORT ECONOMIC GROWTH THIS YEAR, DID NOT INCREASE. ACCORDING TO BANK OF MEXICO DATA TOURISM RECEIPTS WERE UP 4.5 PERCENT IN FIRST QUARTER, WHILE NUMBER OF TOURIST ARRIVALS WAS DOWN 6 PERCENT. WE CONTINUE TO HEAR REPORTS OF SIGNIFICANT DECLINES

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IN HOTEL OCCUPANCY, ESPECIALLY IN ACAPULCO. BANK STATES THAT TOURIST EXPENDITURES ABROAD WERE DOWN IN FIRST QUARTER OF 1976, THOUGH OUR VISA APPLICATIONS WERE UP 24 PERCENT IN FIRST HALF OF 1976 COMPARED TO FIRST HALF OF 1975.

4. THERE IS LESS INFO AVAILABLE ON PUBLIC SECTOR BUDGET WHICH INCLUDES VARIOUS STATE AGENCIES AS WELL AS FEDERAL GOVERNMENT. ACCORDING TO INDIRECT CALCULATION OF BANK OF MEXICO, DEFICIT

FOR TOTAL PUBLIC SECTOR IS RUNNING AT LEVELS BELOW THAT OF YEAR EARLIER. HOWEVER, FEDERAL GOVERNMENT DEFICIT IN FIRST QUARTER OF 1976 WAS 20.9 PERCENT ABOVE THAT OF FIRST QUARTER OF 1975. 25.5 PERCENT INCREASE IN EXPENDIURES OVER SAME PERIOD IS CONSIDERABLY MORE THAN 10 PERCENT ORIGINALLY PLANNED.

5. ANNUAL WAGE SETTLEMENTS NOW BEING NEGOTIATED IN INDUSTRIAL SECTOR ARE RUNNING FROM 15 PERCENT TO OVER 25 PERCENT. THESE INCREASES EXCEED INCREASE IN COST-OF-LIVING OVER PAST YEAR AND PRODUCTIVITY GAINS, THOUGH THERE IS VIRTUALLY NO DATA ON LATTER. NEGOTIATIONS FOR GOVERNMENT WAGE INCREASES ARE BEGINNING NOW AND WILL BE MAJOR TEST OF GOVERNMENT'S SERIOUSNESS IN REDUCING INFLATIONARY PRESSURES.

6. MEXICO CAN GET THROUGH YEAR WITHOUT DEVALUATION AS LONG AS ITS FOREIGN BANKERS ARE WILLING TO MEET "FINANCIAL GAP", OR AS LONG AS MASSIVE RUN ON PESO DOES NOT DEVELOP IN SECOND HALF OF YEAR. BANKERS SEEM TO BE WILLING TO CONTINUE TO MEET MEXICO'S EXTERNAL FINANCIAL REQUIREMENTS. CURRENT SEVEN-YEAR EURO-DOLLAR ISSUE FOR NACIONAL FINANCIERA IS BEING OVERSUBSCRIBED. THIS IS FIRST SEVEN-YEAR ISSUE MEXICO HAS BEEN ABLE TO MARKET FOR SOME TIME, BUT INTEREST RATE IS BEING INCREASED FROM 1.5 PERCENT OVER LONDON INTER-BANK OFFER RATE TO 1.75 PERCENT. BANKERS WERE WILLING TO FINANCE CAPITAL FLIGHT IN FIRST HALF OF 1976. THEY APPEAR WILLING TO CONTINUE DOING SO IN SECOND HALF.

7. IT IS LIKELY THAT GOM WILL GET THROUGH THIS ADMINISTRATION WITHOUT HAVING TO DEVALUE. GREATEST RISK TO THIS WOULD BE ANOTHER SURGE IN CAPITAL FLIGHT THAT EXCEEDED ITS BORROWING CAPACITY. HOWEVER, IT IS UNLIKELY THAT MEXICO'S UNDERLYING COMPETITIVE POSITION WILL BE SIGNIFICANTLY IMPROVED BY END OF  
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THIS YEAR. THIS WILL PRESENT LOPEX-PORTILLO ADMINISTRATION WITH SOME DIFFICULT POLICY CHOICES AS IT ASSUMES POWER.

8. THESE ISSUES, ALONG WITH RELATED STATISTICS, ARE DISCUSSED IN AIRGRAM BEING POUCHED SHORTLY.  
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